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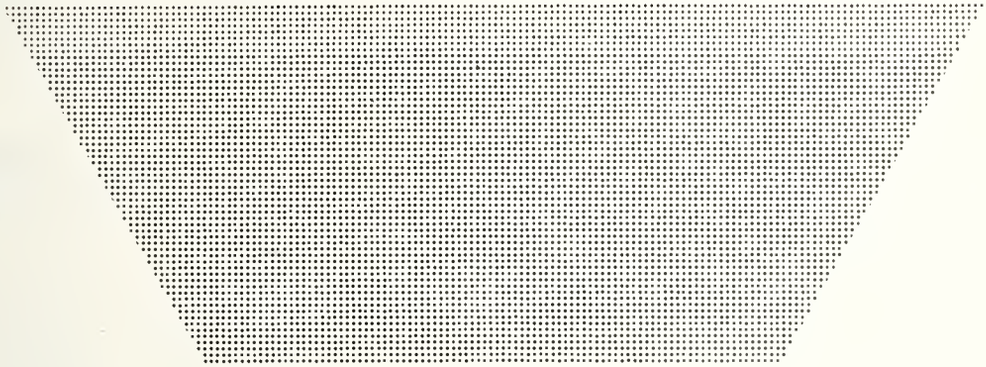
TAX LOSS FARMING



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ABSTRACT

About 43 percent of the 2.9 million individuals filing U.S. farm income tax returns in 1970 reported a farm loss. Forty percent of total farm losses were reported by individuals with less than $5,000 in basic income and about 17 percent were reported by those with $25,000 or more. Generally, farm losses became more frequent as basic income rose.

Over 90 percent of 1970 farm loss returns had a loss of less than $5,000. Losses of $10,000 or more were reported by about 3 percent. These larger losses were concentrated in two basic income classes--those with negative basic incomes and those with $25,000 or more.

Nonfarm income was substantially higher for the farm loss group than for the group reporting farm profits. As expected, farm losses became more important in offsetting nonfarm income as farm size increased.

Directly limiting the amount of farm loss that could be used to offset nonfarm income to $10,000 would have affected 3.3 percent of 1970 farm loss returns. With a $20,000 limitation, 1.2 percent of the farm loss returns would have increased tax liabilities. A $30,000 limitation would have affected 0.6 percent of the returns.

Keywords: Taxation, Agriculture, Tax loss farming, Tax incentives, Farm taxation, Federal income tax data, Tax reform, Farm tax reform, Tax reform proposals.

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SUMMARY

About 43 percent of the 2.9 million U.S. individuals filing farm tax returns in 1970 reported losses--nearly 1.3 million individuals. An analysis of these farm loss returns suggests that "tax loss" farmers who invest in agriculture to shelter nonfarm earnings are not "typical" in U.S. agriculture. But neither are they a rarity.

More than 40 percent of total farm losses were reported by individuals with less than $5,000 in basic income (adjusted gross income plus excluded gains, dividends, and other adjustments to income). However, over 17 percent of reported farm losses were claimed by those with $25,000 or more in basic income. This latter group accounted for about 5 percent of those reporting farm losses but paid 56 percent of the income taxes paid by people reporting farm losses. The higher the basic income the more frequent became the reported farm losses.

More than 90 percent of the 1970 farm loss returns had a loss of less than $5,000. Farm losses of $10,000 or more were reported by about 3 percent of the farm loss returns. These large farm losses were concentrated in two basic income classes--those with negative basic incomes and those with $25,000 or more.

Nonfarm income was substantially higher for the farm loss group than for the group reporting farm profits. Also, the size of nonfarm income increased substantially with the size of the farming operation for the loss group while the level of nonfarm income remained relatively constant for the group reporting farm profits.

Special farm tax rules, when combined with high nonfarm income, can permit the deferral of income tax on nonfarm income. In addition, some farming activities allow the conversion of ordinary income into income from capital gains, which has a lower tax rate. If a farming investment produces a "real" loss, there is little likelihood that the loss will be disallowed for tax purposes. These are the characteristics of an ideal tax shelter. Although much publicity has been given to taxpayers reporting a combination of large nonfarm income and sizable farm loss, little information has previously been available on the characteristics of all returns reporting farm losses.

About 78 percent of the loss returns were from businesses with annual agricultural product sales below $5,000 in 1970. However, farm loss became more important in offsetting nonfarm income as size of farm increased. Certain types of farms--fruit, nut, and vegetable; animal specialty; and miscellaneous--were more apt to have losses than other types. Larger losses were more frequent for fruit, nut, and vegetable; animal specialty; and livestock farms.

Farm losses appeared to be little concentrated in particular geographic regions of the United States, except in Standard Federal Administrative Region 9 (California, Nevada, and Arizona), which reported a high of 63 percent loss returns. However, in all areas, and particularly in regions 2 (New York and New Jersey) and 9, nonfarm incomes of those returns reporting farm losses were substantially higher than for the group with farm profits.

In terms of numbers of U.S. taxpayers and amount of nonfarm income reported, the majority of farm loss returns do not appear to be tax shelters. However, there is some abuse of the farm tax provisions. In effect, tax rules have created a subsidy to a portion of the farming sector, though not necessarily to continuing or ordinary farmers who depend on agriculture as their major source of income.

What if farm losses used to offset nonfarm income were limited to $10,000, $20,000, or $30,000? Such provisions would more or less limit the use of the special tax rules to taxpayers whose primary source of income was from farming operations or whose nonfarm earnings were less than some specified amount. The analysis concentrated on the characteristics of affected returns, based on 1970 farm loss return data.

Limiting farm loss to $10,000 would have affected 3.3 percent of individuals who reported a farm loss in 1970, increasing their income tax liability by 63 percent and resulting in an additional $258 million in Federal tax revenues. With a $20,000 limitation, tax liabilities would have increased for only 1.2 percent of farm loss returns, but revenues would have increased $166 million. Similarly, a $30,000 limitation would affect 0.6 percent of farm loss returns, raising an additional $122 million in revenues.

Farm loss limitations would most affect returns with negative basic incomes and those with basic incomes of $25,000 and over. Approximately 37 percent of the returns, which would have been affected by a $10,000 loss limitation, reported negative basic incomes. The tax liability of this group would have increased from $2.7 million to $74.9 million. About 19 percent of those with basic incomes of $25,000 or more would have been affected by a $10,000 limitation and their tax liability would have increased by $157 million. Two-thirds of the affected returns and 89 percent of the increased revenues would have come from these two groups. Similar results were obtained for $20,000 and $30,000 limitation levels. For a $20,000 limitation, 79 percent of the returns and 92 percent of the increased revenues would have been from these groups. With farm losses limited to $30,000, comparable figures were 84 and 95 percent, respectively.

Fruit, tree nut, and vegetable farms would have higher proportions of returns affected by limitations than would other types of farms, but the increase in tax burden would have been greatest for animal specialty farms, such as horse and mink farms.

Of the Standard Federal Administrative Regions, region 9 had the highest proportion of affected returns, but regions 8 (Utah, Colorado, Wyoming, Montana, and North and South Dakota) and 10 (Washington, Oregon, and Idaho) would have received the greatest increase in tax liabilities, with income taxes more than doubling for farm loss returns in those regions.

Although special farm tax rules benefit persons with large nonfarm incomes more than those with small nonfarm incomes, persons with relatively low farm and nonfarm incomes use them extensively. Individuals in this lower income group are not usually considered tax loss farmers but would, nonetheless, be affected if special tax rules for farmers were completely revoked. Limiting farm losses to any of the three levels examined would affect relatively few lower or moderate income taxpayers except for those with negative basic income, either in terms of basic income or size of farm sales. An approach using a farm loss limitation and a permissible level of nonfarm income would further reduce the impact on lower income taxpayers.

TAX LOSS FARMING

by

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INTRODUCTION

Since Federal income tax was introduced in 1913, numerous changes have been made in the law, usually in the form of special deductions, credits, exclusions, exemptions, and special rates. These changes have been prompted by additional revenue needs, to correct alleged or actual inequities, or for other desirable economic or social purposes. Occasionally special provisions go beyond their intended purposes or outlive the economic or social setting that made them desirable. When this occurs, there are sometimes unintended and undesirable side effects which allow some taxpayers to escape paying their fair share of income tax.

Such provisions are popularly called "tax loopholes." Some argue that the special tax provisions available to farmers have developed into such loopholes. These charges and the limited evidence which supports them have led to proposals ranging from eliminating all special farm tax rules to merely limiting the extent to which farm losses can be used to offset other income.

The primary purposes of this report are to examine various characteristics of farm losses reported on individual Federal income tax returns for 1970 and to determine the effect of directly limiting the amount of farm loss that could be used to offset other income. The development of farm tax rules and the controversy surrounding their use are briefly reviewed to give background for the analysis. Following a discussion of the characteristics of returns with farm losses, major proposals for limiting farm losses are reviewed. The impact of directly limiting farm losses applied against other income to $10,000, $20,000, and $30,000 is then explored.

DEVELOPMENT OF SPECIAL FARM TAX RULES

Special treatment for "farmers" under the provisions of the Internal Revenue Code arises primarily from three sources: (1) A 1915 administrative

decision permitting farmers a choice of accounting methods to use in reporting income for tax purposes; (2) a 1919 Treasury regulation allowing farmers to write off capital expenditures incurred in developing orchards and ranches at the time they occur; (3) legislative action in 1951 confirming that livestock held for draft, breeding, or dairy purposes could be treated as property held for use in a trade or business and thus produce long-term capital gains upon sale. A provision covering livestock held for sporting purposes was added in 1969.

The first two developments allow costs to be deducted before the associated income is realized. The taxpayer then may use these premature deductions to generate a tax loss which is not a true economic loss. This artificial loss may be used to offset income from other sources, thus delaying the receipt of ordinary income for tax purposes. The third development, when combined with the first two, permits ordinary income to be converted into long-term capital gains subject to tax at a lower rate. Note that two of the above sources stem from administrative actions and have never been expressly made a part of the "law" itself.

Cash Accounting

The ability to choose among alternative accounting methods generally reduces to a choice between the accrual method and the cash receipts and disbursements method (the cash method).[1]

In general, Federal income tax regulations require the use of inventories in every case in which the production, purchase, or sale of merchandise produces income. Thus, inventories are required of most mercantile, manufacturing, wholesale, or retail sales businesses, or service establishments where there is a charge for parts, materials, or components. When something is bought, its cost is entered in the account book then, even though it may be paid for later. Anything produced or purchased but not used up or sold during the year is inventoried at the end of the year and tax is paid on its value, or its increase in value if it was included in the beginning inventory. However, despite the above requirements, farmers have been permitted to ignore inventories for income tax purposes and use cash accounting as "an historical concession by the Secretary (of the Treasury) and the Commissioner (of IRS) to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure."[2]

As long as farmers paid little income tax, the choice of accounting method made little difference in revenue and greatly simplified recordkeeping requirements for small family farmers, the purpose for which the rule was intended. As farmers' taxable incomes, income tax rates,[3] and accompanying tax burdens have increased over the years, the cash method has become an excellent means of minimizing and postponing income tax payments.

Current Deduction of Capital Expenditures

Investment spending--the cost of acquiring and developing capital assets--is generally not deductible from income as a current expense for income tax purposes. Instead, these costs are required to be capitalized and recovered through depreciation over the useful life of the asset.

Footnotes appear on p. 34.

Certain "farmers" are allowed to deviate from the general rule. With two exceptions,[4] producers of orchard, grove, and vine crops and breeding livestock are allowed to charge off as current expenses the costs of developing their capital assets to the productive stage, even though no income is produced during this period. This right to currently deduct the costs of raising livestock and developing orchards, groves, vineyards, and similar assets is available to all taxpayers regardless of accounting method used.

Additional specific legislative provisions allow the taxpayers reporting farming operations to deduct certain expenses which, if incurred in other businesses, would be capitalized. These include soil and water conservation expenditures (not to exceed 25 percent of gross income from farming for the year),[5] land clearing expenses or expenditures incurred in making land suitable for farming (limited to the lesser of $5,000 or 25 percent of taxable income from farming during the year),[6] and expenses for fertilizer applied on land used in farming.[7]

Livestock as a Capital Asset

Section 1231 of the Internal Revenue Code treats livestock held for draft, breeding, dairy, or sporting purposes as property used in a trade or business. This means that livestock (except poultry, fish, frogs, or reptiles) held (actual use is not required) for the above purposes is entitled to capital gains treatment upon sale provided holding period requirements are met. These holding periods are 24 months for cattle and horses and 12 months for all other qualifying livestock.

When cash accounting is used the benefit of this provision is multiplied. Expenses of raising the animal are deductible currently and the entire sales price is taxed as a capital gain. If accrual accounting is used, the increased value of the animal is reflected in inventories and the value of section 1231 is diminished although not eliminated.

Of course, purchased livestock held for draft, breeding, dairy, or sporting purposes can be depreciated just as any other purchased capital asset. Prior to 1969 these livestock were specifically exempt from the recapture of depreciation upon sale, a considerable tax advantage.[8] But a provision of the Tax Reform Act of 1969 calling for the recapture of depreciation previously claimed diminished the advantage of section 1231 treatment for purchased livestock (22).

WHO IS A FARMER?

Most, if not all, of the special farm tax rules have apparently been justified on the basis that "farmers" were not able to handle the same accounting systems as other businessmen or needed special incentives to undertake certain capital expenditures viewed as being in the national interest. Which taxpayers are permitted to use these special farm tax rules?

All individuals, partnerships, corporations, estates, and trusts that cultivate, operate, or manage farms for gain or profit,[9] either as owners or

tenants, are designated as "farmers" or "engaged in the business of farming" under Internal Revenue Service regulations (4, Vol. 732, sections 1986A, 1986B). The term "farm" includes stock, poultry, fruit, and truck farms, as well as plantations, ranches, and all land used for farming operations. The term "farmer" includes both owner and tenant where a farm is rented on shares[10] and also a hired farm manager if his compensation is based in whole or in part on the level of farm production. An individual need not live on a farm to be a farmer. Internal Revenue Service regulations governing the use of special farm tax provisions do not specify to what degree a taxpayer must depend on farming for his livelihood in order to qualify as a farmer.

So "farmer," to the Internal Revenue Service, includes the large nonfarm corporation which owns fruit and nut orchards and the New York limited partner of a syndicated investment in cattle in a Texas feedlot as well as the Iowa corn farmer with 400 acres. No wonder someone who views the family farm as the basic unit of American agriculture is confused over the legitimacy of maintaining special farm tax provisions.[11]

THE CHANGING IMPACT OF FARM TAX PROVISIONS

The impact of taxing income derived from farming has only recently received major attention. Until the 1940's, both income from farming and income tax rates were relatively low. However, the post-war trend to large farming units and associated larger capital needs combined with higher income tax rates have made Federal income taxes a significant factor in determining net returns from farm businesses. In addition, investors with substantial nonfarm incomes have become increasingly aware of opportunities to use the farm income tax provisions to shelter income from tax through selective farm investments.

Basic Features of the Tax Structure

The Federal income tax structure is progressive--that is, marginal tax rates increase as income increases. This structure is based on the ability-to-pay principle, or the belief that persons with higher incomes should pay more income taxes than lower income persons in similar circumstances. However, at least two major features of our income tax structure provide a substantial preferential tax advantage to investments by high income taxpayers.

First, the graduated or progressive income tax rate provides an incentive to business spending that is not equal for all taxpayers. To illustrate, assume that a taxpayer is considering spending $100 as a deductible business expense. If he does not make the expenditure, a portion of the $100 must be paid as income tax. If the taxpayer is in the 70 percent (highest) tax bracket, $70 of the $100 would be paid in taxes. His real cost, then, of making the business expenditure is only $30. Contrast this result with that available to the taxpayer in the 14 percent (lowest) tax bracket considering a $100 expenditure. If this taxpayer does not make the deductible expenditure, he must pay $14 as tax. His real cost of a $100 business expenditure is $86--$56 more than the taxpayer in the highest income tax bracket. Thus, for business expenditures under our graduated income tax structure, the amount of benefit is directly proportional to the taxpayer's marginal tax rate. That is, the amount of tax subsidy increases along with taxable income.

A second feature deals with the preferential tax treatment given the gain realized upon the sale of capital assets. Long-term capital gains are taxed at a lower rate than ordinary income. In addition, taxpayers with higher incomes receive a proportionately greater benefit than do those with low incomes. All individuals realizing long-term capital gains have the option of (a) excluding half of their long-term capital gains from taxable income with the remainder taxed at ordinary income tax rates or (b) paying a 25-percent tax on the full amount of the gain.[12]

The former option is obviously preferable for taxpayers whose marginal tax bracket is less than 50 percent. Given the above options, a taxpayer in a 22-percent marginal tax bracket pays an 11-percent tax on his capital gains. A 70-percent bracket taxpayer pays a 25-percent tax on his capital gains.[13] Clearly the relative saving is greater for the high bracket taxpayer.

Thus, high income taxpayers are encouraged to spend relatively cheap dollars in investments which will yield additional future income, preferably in the form of capital gains. It is then advantageous for them to increase deductible expenses in future years to offset the increased income earned then. Business expansion is encouraged as high income taxpayers attempt to minimize income tax obligations.

Consequently, the Federal income tax structure encourages economic expansion, a major goal of national policy. Some tax provisions affect economic growth of all sectors in a similar manner. Other special tax provisions may, by design or unintentionally, emphasize economic growth in particular sectors. When this occurs, the allocation of resources is altered or distorted from what might otherwise have prevailed. Ideally, tax provisions should neither distort resource allocation nor skew income distribution unless these conditions are consistent with recognized national goals.

Also under our present structure, questions of equity arise. Through the combined effects of special provisions and general structure, it has been asserted that the income tax system promotes unequal competition and may widen the income spread between rich and poor relative to what otherwise might be anticipated.

Tax Shelters

A tax sheltered investment is one which produces one or more of three income tax advantages (1, pp. 758-9):

1. The opportunity to incur deductions at ordinary income tax rates in order to earn income taxed at capital gains rates;

2. The ability to, by deducting part, all, or more than the original investment, obtain deductions which shield (for a given period of time) other income from tax; and

3. The assurance that, in the event the investment is unsuccessful, all real losses will be deductible.

Most tax shelters are high risk ventures. As compared with other high risk ventures, the distinguishing feature of tax shelters is that deductions are realized in the early period of the investment (1, p. 760).

Agriculture as a Tax Shelter

The special tax treatment accorded to income from farming, when combined with large amounts of nonfarm income, can produce the three income tax advantages associated with tax shelters.[14] In agriculture, wide publicity has been given the ability of taxpayers with large nonfarm incomes to make farm investments and, using the special farm tax rules, generate artificial losses which are then used to offset, or shelter from tax, the nonfarm income. A substantial proportion of individuals with farm earnings report a farm loss each year on Federal income tax returns (table 1). The proportion of total farm returns reporting a farm loss increased from 34 percent in 1965 to about 43 percent in 1970. It is not known, however, what proportion of these reported losses are artificial losses for tax purposes.

In addition to the question of equity from the standpoint of taxpayers in general, some people feel that the special tax rules, instead of helping farmers, actually foster unfair competition for the farmer who relies on farm income as his sole, or at least major, source of livelihood. This charge is based on the fact that many of the benefits of special farm tax rules are available primarily to the taxpayer who has (1) tax losses which are not economic losses and (2) substantial nonfarm income against which to offset the farm "tax loss." The tax benefit is considerably less to the taxpayer who has only the farm investment.

Table 1--Number of individuals reporting farm profit or loss for income tax purposes, 1965-70

Year	Total number of individuals	Individuals reporting--	
		Profit	Loss
	1,000	----Percent----	
1965	3,064	65.7	34.3
1966	3,020	66.1	33.9
1967	3,030	62.5	37.5
1968	3,043	60.8	39.2
1969	3,089	62.3	37.7
1970	2,906	56.8	43.2

Source: Internal Revenue Service, Statistics of Income: Business Income Tax Returns, U. S. Treasury Department, for respective years.

This competitive advantage may have several implications. Tax benefits available to high-bracket taxpayers may have caused them to bid up the price of farmland beyond that which would have prevailed in the absence of tax benefits. Furthermore, farm operators who depend on farming as their sole or major source of livelihood must compete with those who consider farm profit in the economic sense as less important for their purposes.

Only circumstantial evidence exists to support the above charges. For instance, although the average value per acre of farm real estate has more than doubled since 1960 (7), the phenomenon of increasing farm real estate values has not been fully explained. Although many believe that tax preferences have contributed to these increases, several studies indicate that pressure to expand existing farms is the most significant factor (12, 15). Of all 1972 farmland transfers, 56 percent were for purposes of farm enlargement (7).

For farm output the evidence is not as clear, but for many of the fruit, nut, and vine crops where tax-shelter incentives are particularly prominent, substantial overplanting and overproduction seem to have been the rule in recent years. In beef-cattle production (breeding and feeding), high consumer demand has contributed to generally favorable producer prices although there is some evidence that feeding margins may have been "squeezed" by the presence of funds not requiring as high a before-tax return as more traditional cattle-feeding funds.

It is also possible that "tax-shelter" capital may have contributed to the generally adequate supply of investment capital available to agriculture in recent years. To the extent continuing farmers (as opposed to tax loss farmers) have had access to these tax-motivated funds, capital may have been available at a lower cost than capital from more traditional sources.

USERS OF FARM TAX RULES

At least three groups make extensive use of special tax provisions for U.S. agriculture: (1) Continuing or "ordinary" farmers who depend on agricultural earnings for their major source of income; (2) tax shelter fund investors who are motivated primarily by tax considerations; and (3) investors for whom the tax shelter feature is attractive but not the primary incentive.[15]

Taxpayer and legislative discontent over alleged areas of inequity in the Nation's tax laws has, for agriculture, focused primarily on groups (2) and (3). A study of 1966 Federal income tax returns showed that 75 percent of the 4,778 individuals who reported farming operations and gross incomes over $100,000 deducted $77 million in farm losses from their other income (18). In 1970, the 7,512 taxpayers in this category reported $122 million in farm losses (16, 1970).

Although these statistics have received much publicity, there has been little additional information on the nature of all tax returns showing farm losses. As stated earlier, a primary purpose of this report is to provide information about such returns. A real danger in studying only farm losses reported by high income taxpayers is that proposals to limit apparent abuses of farm tax rules may fail to give adequate consideration to "legitimate" users.

On the other hand, lack of data for all farm loss returns has permitted opponents of tax reform to claim that any attempt to limit farm losses would adversely affect "legitimate" users.

INCOME CONCEPTS AND SOURCES OF INFORMATION

An analysis was made using data from the 1970 Sole Proprietorship Tax Model, the latest available information, developed by the Internal Revenue Service. Special tabulations were prepared by IRS at the request of the authors. At no time did the authors have access to individual income tax records. Provisions for such special statistical studies are made in Section 7515 of the Internal Revenue Code. The IRS tax model is based on a sample taken from all returns having sole proprietorship income in 1970. Only those reporting a farm profit or loss in 1970 were used in this study.

A relatively new income concept, basic income, is used as a distributor in the analysis. Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income.[16] It more nearly reflects the income the taxpayer had available during the year for personal consumption, investment, and to pay taxes than does adjusted gross income. Basic income, however, does not include all income available for these purposes or reflect the net worth of the taxpayer (2). It excludes interest from tax-exempt State and local bonds, transfer payments, and other income not included in the tax return.[17] All reported losses are counted as economic loss even though some are generated for tax purposes.

Farm income is not the only, or even primary, source of income of all people with farm earnings. In 1970, approximately 61 percent of the taxpayers with farm earnings reported wage and salary income. About 12 percent reported a nonfarm business profit or loss. Still others reported income from rents and royalties, partnerships, estates and trusts, and small business corporations. These results are similar to those found by Reinsel based on 1966 income tax data (18).

RETURNS REPORTING FARM LOSSES

Nearly 1.3 million individual taxpayers reported farm losses totaling $3.9 billion in 1970 (table 2). Partnerships reported another $3.9 million in farm losses (16). Sole proprietorships reporting a farm loss paid more total tax than did those reporting a farm profit--they contributed 53 percent of the total taxes collected from the group even though they accounted for only 43 percent of the returns.

Table 2--Basic income, farm earnings, taxable income, and tax liability of people with farm earnings, 1970

Item	Unit	Farm profit	Farm loss	All returns
Returns	1,000	1,651	1,255	2,906
Basic income 1/	mil. dol.	13,418	12,300	25,718
Farm earnings	mil. dol.	5,599	-2,922	2,677
Taxable income	mil. dol.	7,845	7,469	15,314
Tax liability	mil. dol.	1,653	1,871	3,524

1/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income. Taxable income is basic income less all deductions and adjustments and is used to determine tax liability.

Source: Special tabulations by the U.S. Department of Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Although loss returns contribute more to total taxes than profit returns, farm losses are not particularly concentrated in high income returns. Relatively low income taxpayers had the highest proportion of farm losses. For example, proprietors with less than $5,000 in basic income reported more than 40 percent of total losses (table 3). However, relatively high income taxpayers also reported considerable farm losses. Better than 17 percent of reported farm losses were accounted for by proprietors with basic income of $25,000 or more. This group accounted for about 5 percent of total proprietors reporting a farm loss but paid 56 percent of the income taxes paid by the loss group. The probability of a farm return being a loss return increased as basic income increased. For example, about 68 percent of the farm returns with basic income of $50,000 or more reported a farm loss compared with 31 percent of returns with positive basic incomes below $3,500. The large majority of farm losses reported on tax returns in 1970 were less than $5,000 (table 4). This was true for returns from relatively high income classes as well as lower income returns. However, two basic income groups had a disproportionate share of returns with relatively high farm loss--those with negative basic incomes and those having $25,000 or more. For example, almost 5 percent of individuals with basic incomes of $50,000 or more reported farm losses of $50,000 or more. The nonfarm basic income of this group exceeded $100,000.

Table 3--Distribution of basic income, taxable income, and tax liability by basic income size classes, 1970

Item	Negative	Less than $3,500	$3,500-$4,999	$5,000-$7,999	$8,000-$9,999	$10,000-$12,499	$12,500-$14,999	$15,000-$24,999	$25,000-$50,000	$50,000-or more	Mean income
	Percent										Dollars
All returns:											
Returns	4.6	25.1	10.9	19.8	10.8	9.8	6.2	8.6	3.0	1.2	
Basic income 1/		2.1	5.2	14.5	11.0	12.3	9.6	18.1	11.4	15.8	8,850
Taxable income	.2	.8	2.7	11.2	10.1	12.5	10.5	21.0	13.9	17.1	5,270
Tax liability	.3	.5	1.8	7.6	7.3	9.4	8.2	18.0	14.9	32.0	1,210
Returns with farm profit:											
Returns	.6	30.3	12.1	20.5	10.1	9.1	5.9	8.1	2.7	.6	
Farm profit	.7	10.3	7.9	18.4	11.1	11.4	8.8	18.2	9.8	3.4	3,390
Basic income		6.0	6.3	16.3	11.1	12.5	9.9	18.6	10.9	8.4	8,130
Taxable income		1.4	3.4	12.9	10.8	13.2	11.2	22.8	14.3	10.0	4,750
Tax liability	.3	.8	2.5	9.6	8.5	10.9	9.6	21.4	16.7	19.7	1,000
Returns with farm loss:											
Returns	9.9	18.2	9.3	19.1	11.8	10.6	6.6	9.4	3.4	1.7	
Farm loss	22.4	12.6	6.4	12.9	7.7	7.2	4.6	8.4	7.4	10.4	2,330
Basic income		1.9		12.6	10.9	12.1	9.2	17.6	11.9	23.8	9,800
Taxable income		2.8		9.5	9.5	11.8	9.7	19.1	13.4	24.2	5,950
Tax liability	.3	.3	1.2	6.0	6.2	8.1	7.0	14.9	13.2	42.8	1,490

1/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income. Taxable income is basic income less all deductions and adjustments and is used to determine tax liability.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 4--Distribution of farm loss returns within basic income size class by size of farm loss, 1970

Basic income classes 1/	Total returns	Farm loss -- Less than $5,000	$5,000-$9,999	$10,000-$14,999	$15,000-$19,999	$20,000-$34,999	$35,000-$49,999	$50,000 or more
	1,000	Percent						
Negative	124	72.3	15.4	5.8	2.5	2.5	0.7	0.8
Less than $3,500	228	94.5	4.6	.6	.2	.1	.0	.0
$3,500 - $4,999	117	94.3	4.3	1.0	.3	.1	.0	.0
$5,000 - $7,999	237	95.7	3.3	.6	.3	.1	.0	.0
$8,000 - $9,999	149	95.5	3.7	.6	.0	.1	.1	.0
$10,000 - $12,499	133	95.3	3.7	.5	.2	.3	.0	.0
$12,500 - $14,999	83	95.7	3.0	.8	.4	.1	.0	.0
$15,000 - $24,999	118	91.0	6.2	1.4	.5	.7	.2	.0
$25,000 - $49,999	43	75.8	12.5	4.2	2.3	3.3	1.3	.6
$50,000 or more	23	51.9	16.4	8.6	5.9	9.1	3.5	4.6
All returns	1,255	91.0	5.7	1.5	.7	.7	.2	.2

1/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Almost 78 percent of the farm loss returns reported annual agricultural product sales of less than $5,000 in 1970 (table 5). Small farms were much more likely to be operated at a loss than were larger farms. For example, more than 60 percent of the farms with gross sales of less than $2,500 reported a farm loss contrasted to only about 12 percent of farms with sales of $20,000 to $100,000. As might be expected, farm loss became more important in offsetting nonfarm income as farm size increased. For returns reporting gross farm sales in excess of $40,000, average farm losses exceeded average basic income. This group accounted for only about 2.5 percent of total loss returns, but reported 15 percent of total farm losses.

Nonfarm income of individuals reporting farm losses was substantially higher than for those reporting farm profits. In addition, nonfarm income increased as value of farm sales increased for the loss group, while it remained relatively constant for the group reporting farm profits. For example, average nonfarm income for individuals reporting farm sales of less than $2,500 and farm losses was $12,160 while those in the same sales class with farm profits reported average off-farm income of $6,370. For returns with farm sales of $100,000 or more, the loss group reported $46,100 in nonfarm income while the profit group reported $6,760.

As would be expected for returns with farm losses, the probability of a high farm loss appears to increase the value of farm sales increases (table 6). For example, the frequency of farm losses in excess of $10,000 was much higher for those farms with annual sales in excess of $40,000 and reporting a farm loss than for smaller units. Among farms with annual sales of $100,000 or more and a farm loss, more than 30 percent reported a loss of $20,000 or more. Thus, large farm units reporting a high farm loss are a relatively small proportion of the total farm loss returns, but report the major portion of farm losses.

The incidence of farm loss was high for animal specialty and miscellaneous type farms (table 7). However, returns from these farm types were a relatively small proportion of all returns in 1970. About half of the returns for fruit, tree nut, and vegetable farms reported a farm loss. The types of farms having higher proportions of farm loss also had higher levels of basic income.

Fruit, tree nut, and vegetable farms had a higher proportion of larger farm losses than did the other farm types (table 8). Although animal specialty and miscellaneous type farms had higher incidences of farm loss, their share was not necessarily disproportionate. Fruit, tree nut, and vegetable; livestock; and animal specialty farms had somewhat higher proportions of farms with losses in excess of $20,000.

Incidence of farm loss varied less by Standard Federal Administrative Regions (figure 1) than by type of farm (table 9). In region 9, about 63 percent of the returns showed a farm loss, the highest of any region. Only about one-third of the returns from regions 7 and 8 reported farm losses. The proportion with losses was also low in regions 4 and 5, about 40 percent. Loss returns in the remaining regions averaged between 45 and 55 percent of total returns. Region 9 appeared to have a somewhat higher proportion of large farm losses than the other regions (table 10).

Table 5--Average basic income, taxable income, and tax liability by value of farm products sold, 1970

Item	Unit	Value of sales						
		Less than $2,500	$2,500-$4,999	$5,000-$9,999	$10,000-$19,999	$20,000-$39,999	$40,000-$99,999	$100,000 or more
All returns:								
Returns	1,000	1,276	414	395	380	277	131	33
Basic income 1/	Dollars	9,320	6,930	7,050	7,660	9,840	13,290	24,117
Taxable income	Dollars	5,580	3,870	3,890	4,350	5,920	8,910	18,030
Tax liability	Dollars	1,250	860	866	958	1,310	2,230	6,310
Tax/basic income	Percent	13.4	12.4	12.3	12.5	13.3	16.8	26.2
Returns with farm profit:								
Returns	1,000	468	249	273	296	233	107	25
Basic income 1/	Dollars	7,040	6,050	6,660	7,740	10,170	14,260	24,700
Farm profit	Dollars	670	1,330	2,360	4,190	6,620	10,120	17,940
Taxable income	Dollars	4,100	3,220	3,570	4,320	6,050	9,440	18,320
Tax liability	Dollars	860	650	710	850	1,220	2,140	5,370
Tax/basic income	Percent	12.2	10.7	10.7	10.9	12.0	15.0	21.7
Returns with farm loss:								
Returns	1,000	808	165	122	84	44	24	8
Basic income 1/	Dollars	10,640	8,260	7,920	7,360	8,070	8,990	22,400
Farm loss	Dollars	1,520	2,070	2,780	3,780	5,870	9,880	23,700
Taxable income	Dollars	6,430	4,850	4,600	4,490	5,260	6,550	17,180
Tax liability	Dollars	1,480	1,170	1,220	1,360	1,810	2,630	9,040
Tax/basic income	Percent	13.9	14.2	15.4	18.4	22.4	29.3	40.3

1/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income. Taxable income is basic income less all deductions and adjustments and is used to determine tax liability.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 6--Distribution of farm loss returns within value of sales classes by size of farm loss, 1970

Value of gross sales	Total returns	Farm loss--						
		Less than $5,000	$5,000-$9,999	$10,000-$14,999	$15,000-$19,999	$20,000-$34,999	$35,000-$49,999	$50,000 or more
	1,000	Percent						
Less than $2,500	808	95.7	3.1	0.6	0.3	0.2	0.1	0
$2,500 - $4,999	165	92.3	5.5	1.2	.5	.3	.1	.1
$5,000 - $9,999	122	85.9	9.9	2.2	1.0	.8	.2	0
$10,000 - $19,999	84	78.3	15.1	3.1	1.7	1.2	.4	.2
$20,000 - $39,999	44	69.8	15.4	7.3	2.3	3.4	.9	.9
$40,000 - $99,999	24	51.6	19.6	10.5	6.6	6.7	2.5	2.5
$100,000 or more	8	37.6	17.0	9.6	5.4	14.3	5.9	10.2
All returns	1,255	91.0	5.7	1.5	.7	.7	.2	.2

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 7--Number of returns and average basic income, taxable income, and tax liability by type of farm, 1970 1/

Item	Unit	Field crop	Fruit, tree nut, and vegetable	Live-stock	Animal specialty	Miscel-laneous types
All returns:						
Number	1,000	1,059	129	1,511	54	153
Basic income 2/	Dollars	8,880	12,820	7,870	12,900	13,650
Taxable income	Dollars	5,530	8,060	4,420	8,020	8,600
Tax liability	Dollars	1,220	2,150	1,000	1,960	2,230
Tax/basic income	Percent	13.7	16.8	12.7	15.2	16.4
Returns with farm profit:						
Number	1,000	693	63	854	6	35
Basic income 2/	Dollars	8,650	11,510	7,280	13,010	11,860
Farm profit	Dollars	2,860	4,160	3,370	3,390	3,230
Taxable income	Dollars	5,430	7,390	3,880	7,310	7,580
Tax liability	Dollars	1,150	1,840	774	2,070	1,853
Tax/basic income	Percent	13.3	16.0	10.6	17.3	15.6
Returns with farm loss:						
Number	1,000	366	66	658	47	118
Basic income 2/	Dollars	9,300	14,080	8,630	13,020	14,180
Farm loss	Dollars	1,860	3,150	2,560	2,690	1,910
Taxable income	Dollars	5,710	8,700	5,120	8,110	8,910
Tax liability	Dollars	1,330	2,440	1,300	1,950	2,350
Tax/basic income	Percent	14.3	17.3	15.0	15.0	16.5

1/ Type of farm is based on definitions used in the Standard Industrial Classification Manual, 1967, modified where necessary to accommodate the tax data.
2/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income. Taxable income is basic income less all deductions and adjustments and is used to determine tax liability.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 8--Distribution of farm loss returns within type of farm by size of farm loss, 1970

Type of farm 1/	Total returns	Farm loss -- Less than $5,000	$5,000-$9,999	$10,000-$14,999	$15,000-$19,999	$20,000-$34,999	$35,000-$49,999	$50,000 or more
	1,000	Percent						
Field crop	366	93.0	4.9	1.1	0.4	0.4	0.1	0.1
Fruit, tree nut and vegetable	66	85.1	8.2	3.1	1.5	1.3	.4	.4
Livestock	658	90.2	6.0	1.6	.8	.8	.3	.3
Animal specialty	47	90.2	6.0	1.0	1.0	1.2	.3	.3
Miscellaneous types	118	92.6	5.0	1.1	.6	.5	.1	.1
All returns	1,255	91.0	5.7	1.5	.7	.7	.2	.2

1/ Type of farm is based on definitions used in the Standard Industrial Classification Manual, 1967, modified where necessary to accommodate the tax data.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

STANDARD FEDERAL ADMINISTRATIVE REGIONS
ALASKA
WASH.
OREG.
10
IDAHO
MONT.
N. DAK.
S. DAK.
WYO.
8
UTAH
COLO.
CALIF.
NEV.
9
ARIZ.
NEBR.
IOWA
KANS.
7
MO.
MINN.
WIS.
5
ILL.
MICH.
IND.
OHIO
ME.
1
VT.
N.H.
MASS.
R.I.
CONN.
N.Y.
2
PA.
3
N.J.
DEL.
MD.
W. VA.
VA.
N. MEX.
TEXAS
OKLA.
ARK.
LA.
6
KY.
TENN.
N.C.
S.C.
MISS.
ALA.
GA.
4
FLA.
HAWAIIAN ISLANDS
KAUAI
OAHU
MAUI
HAWAII
PUERTO RICO
VIRGIN ISLANDS
ST. THOMAS
ST. JOHN
ST. CROIX

Figure 1

Table 9--Average basic income, taxable income, and tax liability by Standard Federal Administrative Regions, 1970

	Unit	1	2	3	4	5	6	7	8	9	10	United States
All returns:												
Number	1,000	28	57	166	590	730	436	494	192	111	102	2,906
Basic income 1/	Dollars	10,350	14,090	10,110	8,050	8,740	9,390	7,520	7,300	14,940	9,350	8,850
Taxable income	Dollars	5,860	7,900	6,060	4,710	5,110	5,980	4,430	4,010	9,380	5,660	5,270
Tax liability	Dollars	1,520	2,350	1,510	1,070	1,110	1,500	910	800	2,540	1,190	1,210
Tax/basic income	Percent	14.7	16.7	14.9	13.3	12.7	16.0	12.0	11.0	17.0	12.7	13.7
Returns with farm profit:												
Number	1,000	15	29	88	326	441	205	327	129	41	50	1,651
Basic income 1/	Dollars	9,280	10,400	8,260	6,570	8,440	8,450	7,860	7,720	14,870	9,650	8,130
Farm profit	Dollars	3,970	3,920	2,860	2,030	3,300	3,570	3,980	4,200	6,130	4,680	3,390
Taxable income	Dollars	5,260	6,190	4,810	3,700	4,840	5,280	4,550	4,200	10,230	5,960	4,750
Tax liability	Dollars	1,160	1,490	1,050	780	990	1,190	890	820	2,630	1,240	1,000
Tax/basic income	Percent	12.5	14.3	12.8	11.9	11.7	14.1	11.4	10.6	17.7	12.9	12.3
Returns with farm loss:												
Number	1,000	13	28	78	264	289	231	167	63	70	52	1,255
Basic income 1/	Dollars	11,560	17,790	12,200	9,870	9,200	10,230	6,850	6,420	14,970	9,040	9,800
Farm loss	Dollars	2,810	3,400	2,170	1,930	1,920	2,550	2,090	2,830	4,420	2,490	2,328
Taxable income	Dollars	6,540	9,620	7,470	5,960	5,540	6,600	4,190	3,630	8,880	5,380	5,950
Tax liability	Dollars	1,920	3,220	2,020	1,420	1,300	1,770	930	780	2,480	1,130	1,490
Tax/basic income	Percent	16.6	18.1	16.6	14.4	14.1	17.3	13.6	12.2	16.6	12.5	15.2

1/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income. Taxable income is basic income less all deductions and adjustments and is used to determine tax liability.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 10--Distribution of farm loss returns within Standard Federal Administrative Regions by size of farm loss, 1970

Region	Total returns	Farm loss--						
		Less than $5,000	$5,000-$9,999	$10,000-$14,999	$15,000-$19,999	$20,000-$34,999	$35,000-$49,999	$50,000 or more
	1,000	Percent						
1	13	88.1	6.0	2.2	1.5	1.7	0.2	0.3
2	28	87.0	6.8	1.8	1.5	1.9	.5	.5
3	78	91.4	6.2	1.1	.5	.6	.2	0
4	264	93.5	4.2	1.2	.4	.5	.1	.1
5	290	92.7	5.1	1.1	.5	.4	.1	.1
6	231	90.2	6.1	1.6	.8	.7	.3	.3
7	167	91.5	5.9	1.4	.6	.4	.1	.1
8	63	89.0	6.6	1.9	.8	1.0	.4	.3
9	70	82.2	8.4	3.5	2.1	2.2	.8	.8
10	51	87.7	8.7	1.8	.6	.9	.2	.1
All returns	1,255	91.0	5.7	1.5	.7	.7	.2	.2

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Nonfarm basic income reported by returns with farm profits and those with farm losses differed distinctly by region. For all regions of the country, returns with farm profits reported an average nonfarm basic income of $4,740 and the loss returns, $12,128. The most pronounced difference was found in region 2, where the loss group reported $21,190 in nonfarm basic income compared with $6,480 for the returns with farm profits. Region 9 loss returns had $19,390 in nonfarm basic income while profit returns reported $8,740, the highest nonfarm basic income for any region's farm profit returns.

To summarize, the bulk of farm losses were reported by individuals with low basic incomes. In addition, most farm losses were reported from small farms, as measured by value of agricultural products sold. Except in region 9, farm losses were not overly concentrated in particular geographic regions of the United States, but nonfarm basic incomes of individuals reporting farm losses were substantially higher in regions 2 and 9 than in other areas. Farm loss was more likely on some types of farms than on others. More than 90 percent of the returns reporting farm losses had a loss of less than $5,000, while 0.2 percent reported $50,000 or more in farm losses. These data do not refute the existence of high income tax loss farmers who own or invest in a large farming business operated at a loss for the purpose of reducing income tax liability. However, they do suggest that such individuals are not typical in American agriculture.

But while high income tax loss farmers may not be typical, their losses are probably motivated more by tax than real economic considerations. Nonfarm income was substantially higher for individuals reporting farm losses than for those reporting profits. For instance, (1) returns reporting farm sales of $100,000 or more reported seven times as much nonfarm income as did those with farm profits; (2) three times as many individuals with basic incomes of $50,000 or more reported farm losses than reported farm profits; and (3) there was a distinct tendency for larger farm loss returns to be found in Standard Federal Administrative Regions containing major cities.

If special farm tax provisions are intended to benefit taxpayers primarily dependent upon farming for their livelihood, these special rules appear to be abused by taxpayers seeking tax shelters. However, the majority of farm loss returns, in terms of size of loss and amount of nonfarm income reported, do not appear to be tax shelters. These, in the absence of additional information, may be considered by many as "legitimate" farm losses claimed by the intended beneficiaries.

PROPOSALS TO LIMIT FARM TAX PROVISIONS

There is considerable speculation that special farm tax provisions may have contributed to recent changes in farm structure. In effect, tax rules have created a subsidy to a portion of the farming sector--but not necessarily to continuing farmers. Major and unintentional distortions in resource allocation and income distribution can and possibly have resulted from income tax laws and rulings. The speculation that these distortions may have been unnecessary or undesirable has given rise to proposals to limit the use of farm tax provisions.

Clearly the special farm tax provisions have reduced tax revenues. Annual revenue losses due to special farm tax rules are estimated at about $900 million (13, p. 4). This includes benefits from both tax deferral and the conversion of ordinary income into capital gains.

There is a difference between direct subsidies, such as farm program payments, and indirect subsidies typified by special tax provisions. Direct subsidies are subject to the usual budgetary constraints including periodic review, identification of recipients, and limitations on amounts paid to recipients. For the tax subsidy, however, there is no established procedure for review, there is no certainty as to who receives this subsidy, and there are no limitations on benefits to individual recipients.

Proposals to curb abuses of special farm tax rules range from the complete elimination of the cash accounting privilege and associated special tax provisions to various limitations on the amount of nonfarm earnings which could be offset by farm losses. Most of these proposals, however, would continue to permit taxpayers whose primary source of income was from farming to use the special farm tax provisions.

Many farm tax spokesmen admit the need for curbing agricultural tax shelters but argue that any such measures should distinguish between the use of farm tax rules to generate artificial (not economic) losses to offset nonfarm income, and traditional tax management strategies followed by ordinary, continuing farmers to even out taxable income from year to year. The essential difference between the two is that the special rules, as a farm income tax management strategy, are used to even out farm income and not necessarily to produce a farm loss.

Other reformers argue that existing rules are too liberal even if restricted to use by continuing farmers. They feel that the interests of equity and other national goals would be best served by placing farmers on more nearly the same income reporting basis, for income tax purposes, as other businessmen.

Tax Reform Act of 1969 and the Excess Deductions Account

The formal proposals introduced as bills in Congress have resulted largely from the publicity given nonfarmers who use farm tax provisions to generate artificial losses which offset nonfarm income. Most of these proposals have concentrated on limiting the amount of farm losses which can be used to offset nonfarm income. The only proposal actually enacted into law to date, however, was contained in the Tax Reform Act of 1969, and required the use of a special accounting procedure for "excess" farm losses (22, pp. 2-5).

Although all farm losses can continue to be deducted from nonfarm income, for taxpayers with nonfarm adjusted gross incomes over $50,000, the excess of farm losses over $25,000 must now be placed in a special excess-deductions account (EDA). Gain on the subsequent sale of "farm recapture property"[18] must be treated as ordinary income to the extent of EDA balances. Amounts in an EDA are reduced by farm income in subsequent years and to the extent that they are used to offset capital gains on the sale of farm property. For example, suppose a taxpayer with a nonfarm adjusted gross income of $50,000 reports a farm loss of $30,000. He would claim the $30,000 farm loss but credit

his EDA account for $5,000. Thus in a subsequent year, the first $5,000 realized for the sale of farm recapture property would be treated as ordinary income. The remainder of the sale, assuming no subsequent additions to EDA, would be handled as capital gains. This provision continues to allow tax payment to be delayed but limits the tax-reduction feature for taxpayers meeting its tests.[19]

Two other provisions of the 1969 Act restricted capital-gains treatment of beef-breeding herds. First, the required holding period to qualify for capital-gains treatment was extended from 1 to 2 years. Second, breeding stock was made subject to the recapture of previously claimed depreciation upon sale. These provisions, like the EDA, limit the ability to convert ordinary income into capital gains. The 1969 legislation reduced but did not eliminate tax inducements for investments in beef-breeding herds. In a study made at the University of Missouri, it was estimated that after-tax profits (average for all investors without regard to marginal income tax bracket) of a typical nonfarm investor-owned beef-breeding herd may have been reduced by approximately one-third (19). For reasonably careful investors, however, the breeding herd tax shelter continues to exist even though it is somewhat less profitable (3).

The 1969 Tax Reform Act also required that expenditures for planting, cultivating, maintaining, or developing citrus groves be capitalized if they are incurred within 4 years after the grove is planted. A year later these tax requirements were extended to almond groves. Development expenses may still be deducted prematurely for all other orchard-type crops.

Several observations may be made about the 1969 legislation. The EDA continues to allow capital costs. Since EDA recapture is not activated unless there is a sale of assets the "deferral" feature of tax shelters is not affected. EDA operates only on farm loss in excess of $25,000 and then only if the taxpayer has nonfarm income over $50,000. Therefore, it appears that prudent tax shelter investors could, in many cases, manage their farm investments to limit their losses to $25,000 or less. New plantings of citrus and almonds are no longer advertised as tax shelters but other grove and vine crops are. In addition, some tax shelter opportunity still exists for citrus (and possibly almonds as well) in the renovation of diseased or freeze-damaged groves.

Revoking Cash Accounting and Capital Cost Write-Offs

The most sweeping proposal would completely change the accounting procedures presently permitted those filing farm tax returns.[20] No one denies that changing to an accrual accounting system would present problems (6, 23). The initial, one-time surge of income resulting from the establishment of inventories is the primary objection. This impact could presumably be alleviated, however, by making these adjustments over a period of time ranging from 3 to 10 years. Such a procedure is already authorized by the Internal Revenue Code. In cases where assets previously written off through depreciation are required to be included in inventory, capital gain would be converted to ordinary income. Although farm inventory methods recognized by IRS leave much to be desired (6, 11), some tax experts recommend this approach (6, p. 27).

Revoking the cash accounting privilege alone would affect, in varying degrees, 97 percent of individuals filing farm tax returns (the approximate percentage filing by the cash method in 1968) (16). Should the additional general and specific regulations (see pp. 4-6) be revoked, virtually all farm returns would be affected to some extent. Such an approach, it is claimed, would eliminate the tax distinction between farming and other businesses. It might be desirable, however, to preserve cash accounting for certain low income farmers.

Direct Farm Loss Limitations

Most proposals to limit the use of farm losses to offset nonfarm income implicitly assume that the simplified accounting rules should be preserved for continuing or "real" farmers. "Real" farmers are generally defined on the basis of their lack of income from nonfarm sources. These proposals assume that if nonfarm income is above a specified level, either the particular farming operation is used as a tax shelter or the special tax rules generate such substantial benefits for high income people that they should be denied in the interests of equity.

Early Version. One early version of this approach would limit to $15,000 or the amount of certain "special deductions,"[21] whichever was higher, the amount of farm loss which could be deducted from nonfarm income. For nonfarm adjusted gross incomes over $15,000, the amount of allowable farm loss was reduced dollar for dollar. For example, if nonfarm adjusted gross income was $20,000, only $10,000 in farm losses could be deducted. For nonfarm adjusted gross incomes over $30,000, no farm loss could be deducted. The $15,000 limit could, however, be raised to the level of "special deductions," if necessary.

Disallowed losses, reduced by the untaxed portion of farm capital gains, could be carried back 3 and forward 5 years to offset farm income only. Farm losses were defined as the amount by which farm deductions exceeded gross farm income. Farm deductions included all allowable items attributable to the farming activities. The untaxed one-half of long-term farm capital gains was not included in income for calculating farm loss.

Taxpayers who elected to use inventories and capitalize invested expenditures would be exempt from the provisions of this proposal and could continue to deduct any losses. Thus, this proposal would preserve cash accounting and other special rules for those farmers who had not made "excessive" use of them.

Current Version. The most recent version of this approach[22] proposes to limit full deduction of farm losses to taxpayers with nonfarm adjusted gross incomes of $20,000 or less. For taxpayers with nonfarm adjusted gross incomes over $20,000, the amount of allowable farm loss would be the higher of $10,000 or the amount of the "special deductions" described in the early version.

Disallowed losses could be carried over to following years. Apparently there would be no limit to this carryover either in amount or in number of years. As in the earlier version, taxpayers electing accrual accounting would be exempt from this proposal.

Taxpayers engaged in more than one farming operation would treat their operations as one business for tax purposes. Similarly, taxpayers engaged in farming and also one or more businesses related to farming might elect to treat all such businesses as a single farming business.

Limiting Farm Loss Deductions to Farmers

Another proposal would limit farm deductions of nonfarmers to the amount of gross farm receipts, except for individuals whose principal residence was on a farm. In this case the limit on farm deductions would be the total of gross farm receipts, wages and salaries, timber income, and royalties derived from farm property. A farmer, defined as a taxpayer whose net income from farming for the 3 preceding years has equaled two-thirds of his total net income, could claim all his deductions. Net farm income here includes the full amount of gain on the sale or exchange of assets. Total net income excludes all such gains except those associated with farm assets.

Most loss limitation proposals have the problem of defining farm income and expense. This proposal, in addition, presents the problem of defining a farm and a principal residence. "Farmers" could continue to offset nonfarm income with farm losses. Nonfarmers could also continue to offset certain types of nonfarm income if they lived on a farm.

Limiting Artificial Accounting Losses

In 1973 the Treasury Department released a tax reform package including a proposed "Limitation on Artificial Accounting Losses" (LAL) which was specifically designed to prevent high income individuals from sheltering their incomes from tax (21). LAL dealt with current deductions clearly associated with the future production of income. For agriculture, deductions which were specifically identified included prepaid feed and development expenses.

The proposal would not repeal or change any of the accounting or accelerated deduction provisions of the present law. If the special deductions created a loss, however, that loss could not be used to offset or shelter other unrelated income of the taxpayer. The loss would have to be placed in a special Deferred Loss Account and carried over until the activity to which the loss was related began to produce income. At that time the loss could be used to offset such income as rapidly as it was generated. Thus, the taxpayer would still be able to shelter income from the investment itself, but could not shelter other nonrelated income.

In general, LAL was not intended to affect those taxpayers regularly and profitably engaged in a business activity. In the case of farming, income from all farming units in which the taxpayer was personally engaged would be treated as a single related class. Thus, for example, a farmer could continue to offset crop income with losses generated in cattle breeding or feeding.

The proposal stated that LAL was intended to affect relatively few taxpayers. LAL distinguishes between existing investments, regardless of the extent to which they might have been tax-motivated, and investments which might be initiated or increased following the enactment of LAL. The former, it seems, would be substantially unaffected as long as the increase in accelerated deduc-

tions does not exceed 20 percent over the previous year or can be justified by the particular facts and circumstances of the individual case. New investments would be subject to loss deferrals to the extent that the losses were "artificial," that is, created by claiming designated accelerated deductions. The postponement of the loss, however, would rarely be for more than 2 years.

This emphasis on the increase in the level of accelerated deductions, rather than their absolute level, appears to be the key to the interpretation of LAL. The Treasury proposal stated:

> "Since it is only the net increase in accelerated deductions which can create a loss distortion, ... (LAL)...will be inapplicable unless there has been a major increase during the year in the level of operations or of investments of a type which would be capitalized or inventoried in a business other than farming." (21, p. 100)

Therefore, it appears that the only losses which would be placed in the Deferred Loss Account are first-year losses arising from accelerated deductions and losses caused by rapid expansion in the scale of operations.

Tax Credits Instead of Deductions

Another proposal, which will be only briefly mentioned, would replace special deductions with tax credits. A tax credit can be more significant than a deduction of an equal amount. A deduction produces a tax benefit to the extent of the taxpayers' marginal tax bracket multiplied by the amount of the deduction. Tax credits, on the other hand, are applied directly against the tax and reduce it dollar for dollar.

This proposal would not directly limit the extent farm losses can be used to offset nonfarm income. But an attractive feature of such an approach, from an equity standpoint, is that the amount of tax benefit would no longer be tied directly to the taxpayer's marginal tax bracket.[23] The dollar benefit would be the same, regardless of the taxpayer's level of taxable income. Such an approach might be preferable to existing legislation authorizing the current deduction of capital expenditures such as soil and water conservation expenditures.

EFFECTS OF LIMITING FARM LOSSES

Most proposals to limit farm losses are accompanied by estimates of number of returns affected and their revenue impact. There has been little information about the characteristics of affected returns. The general impact of limiting farm losses was analyzed at three levels: $10,000, $20,000, and $30,000. The analysis concentrates on the characteristics of affected returns. Although precise evaluations of specific proposals to limit farm tax provisions were not undertaken, the data below indicate the general impact of many of the formal proposals.

First, tabulations were made by IRS based on information provided by taxpayers in 1970. Then, the farm loss reported on schedule F was limited to

$10,000, $20,000 and $30,000, respectively. Taxable income and tax liability were recomputed by IRS and new tabulations were made. The results were compared with the original information. All results reflect the change that would have occurred in 1970 had a farm loss provision been in force.

Limiting farm losses to $10,000 would have affected 3.3 percent of those individuals reporting a farm loss in 1970 (table 11). An additional $258 million in Federal income tax revenue would have been generated--an increase of about 17 percent in the taxes paid by people with a farm loss. For those affected, however, tax liability would have increased by 63 percent. Increasing the cutoff to $20,000 or $30,000 would substantially reduce the total number of returns affected. For example, only about 1.2 percent of the loss returns would have had an increase in tax liability as a result of limiting farm losses to $20,000. However, revenues would have increased about $166 million.

Regardless of the cutoff level, the effect of limiting farm losses would not be the same at all income levels. Approximately 37 percent of the returns affected by a $10,000 loss limitation had a negative basic income. The tax liability of this group would have increased almost 27 times, from $2.7 million to $75 million. Many other taxpayers with relatively low basic incomes would also be substantially affected by such a proposal. For example, although only 1 percent of those with basic incomes of less than $3,500 would experience an increase in tax liability resulting from a $10,000 farm loss limitation, the tax increase for those affected would be fourteenfold.

A farm loss limitation would also substantially affect a large percentage of returns with basic income of $25,000 or more. About 19 percent of the returns in this group would have had an increase in taxes with a $10,000 cutoff. This represents about 30 percent of the total affected returns. The affected returns at the $25,000 or more income level would have experienced a 40-percent increase in taxes.

Thus, limiting the amount of farm loss claimed against nonfarm income would substantially affect two groups, those with negative basic incomes and those with high basic incomes. Fewer returns would be involved at each income level between zero and $25,000 but for those people with low basic income who would experience a tax increase, the increase would be substantial. Those with a negative basic income in 1970 would have been much more adversely affected as the result of a cutoff than those with incomes of $25,000 or more.

Setting farm loss limits at higher cutoff levels would affect fewer returns, but the proportion of affected returns with incomes of $25,000 or more would substantially increase. For example, 44 percent of the affected returns at the $20,000 cutoff had basic incomes of $25,000 or more. At the $30,000 cutoff, 49 percent of the affected returns had $25,000 or more in basic income. This is because a higher proportion of the returns with high basic incomes reported substantial farm losses. However, the proportion of affected returns with negative incomes would remain about the same regardless of cutoff level.

Table 11--Increase in tax liability as a result of limiting farm losses to $10,000, $20,000, and $30,000 by basic income size classes, 1970

Basic income classes 1/	Total returns	Farm loss limited to -- $10,000			$20,000			$30,000		
		Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase
	1,000		Mil. dol.		1,000	Mil. dol.		1,000	Mil. dol.	
Negative	124	15.2	2.7	72.3	5.0	1.9	49.9	2.5	1.3	39.0
Less than $3,500	228	2.3	.3	4.4	.5	.2	1.9	.2	2/	1.0
$3,500 - $4,999	117	1.7	.2	2.2	.2	.1	.9	.1	2/	.5
$5,000 - $7,999	237	2.7	1.2	4.3	.5	.1	1.5	.2	2/	.9
$8,000 - $9,999	149	1.4	.7	2.5	.3	.1	.9	.1	.1	.5
$10,000 - $12,499	133	1.4	1.4	3.6	.4	.5	1.6	.1	.2	1.0
$12,500 - $14,999	83	1.1	1.1	2.2	.1	.1	.9	.1	.1	.4
$15,000 - $24,999	118	3.3	6.3	9.6	1.1	1.7	4.1	.4	.7	2.2
$25,000 - $49,999	43	5.1	28.6	32.2	2.4	12.4	17.5	1.2	5.8	10.6
$50,000 or more	23	7.4	364.9	124.6	4.0	242.4	87.2	2.4	171.1	65.6
All returns	1,255	41.6	408.4	257.9	14.5	259.5	166.4	7.3	179.3	121.7

1/ Basic income is defined as adjusted gross income plus excluded capital gains, dividends, and other adjustments to income. Taxable income is basic income less all deductions and adjustments and is used to determine tax liability.
2/ Less than $50,000.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Returns filed by taxpayers with larger farming operations would be influenced more by a farm loss limitation than would those with smaller farms (table 12). Almost half of the loss returns reporting farm sales of $100,000 or more would experience an increase in tax liability given a $10,000 loss limitation. The tax bill of this group would have doubled as a result of the limitation. Although about a quarter of the returns affected by the $10,000 cutoff were from farming operations grossing less than $2,500 in farm sales, this is far less than the proportion of total loss returns in that class. As the cutoff increased in size, the proportion of affected returns from larger farms increased substantially.

Differences noted earlier among farm types are also evident for farm loss limitations. A higher proportion of fruit, tree nut, and vegetable farms would experience a tax increase if farm loss limitations were imposed (table 13). A $10,000 limitation would increase the tax burden of animal specialty farms (such as horse farms, mink ranches, and game farms) more than other types. Miscellaneous farm types with tax increases had the smallest changes in tax liability at the $10,000 cutoff level.

Although region 9 had a somewhat higher proportion of returns affected by a $10,000 cutoff, people experiencing a tax increase in that region were not the hardest hit (table 14). Taxes more than doubled for those returns in regions 8 and 10.

Table 12--Increase in tax liability as a result of limiting farm losses to $10,000, $20,000, and $30,000 by value of farm products sold, 1970

Value of farm products sold	Total returns	Total loss returns	Farm losses limited to -- $10,000			$20,000			$30,000		
			Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase
	1,000			Mil. dol.		1,000	Mil. dol.		1,000	Mil. dol.	
Less than $2,500	1,276	808	10.0	120.8	53.1	3.1	60.5	28.7	1.4	28.1	18.1
$2,500 - $4,999	414	165	3.6	32.2	12.8	.8	12.9	6.1	.3	5.3	3.6
$5,000 - $9,999	395	122	5.2	43.4	18.8	1.3	25.9	9.1	.5	16.5	5.7
$10,000 - $19,999	380	84	5.6	51.7	24.7	1.6	31.2	13.6	.7	21.2	8.5
$20,000 - $39,999	277	44	6.5	43.6	32.9	2.3	30.2	20.2	1.1	21.6	13.8
$40,000 - $99,999	131	24	6.9	46.6	44.4	2.8	34.9	29.7	1.7	28.3	21.8
$100,000 or more	33	8	3.8	69.1	71.2	2.6	63.9	59.0	1.6	58.3	50.2
All returns	2,906	1,255	41.6	407.4	257.9	14.5	259.5	166.4	7.3	179.3	121.7

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 13--Increase in tax liability as a result of limiting farm losses to $10,000, $20,000, and $30,000 by type of farm, 1970

Type of farm 1/	Total returns	Total loss returns	Farm losses limited to - $10,000			$20,000			$30,000		
			Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase
	1,000			Mil. dol.		1,000	Mil. dol.		1,000	Mil. dol.	
Field crop	1,059	366	7.8	56.9	38.7	2.3	32.0	24.7	1.1	22.7	18.1
Fruit, tree nut and vegetable	129	66	4.3	30.3	22.4	1.4	14.7	13.5	.7	8.7	9.4
Livestock	1,511	658	24.8	264.4	165.2	9.1	179.3	108.3	4.7	129.9	79.7
Animal specialty	54	47	1.9	20.3	17.0	.9	12.5	11.6	.5	8.7	8.7
Miscellaneous types	153	118	2.8	35.5	14.6	.8	21.0	8.3	.3	9.3	5.8
All returns	2,906	1,255	41.6	407.4	257.9	14.5	259.5	166.4	7.3	179.3	121.7

1/ Type of farm is based on definitions used in the Standard Industrial Classification Manual, 1967, modified where necessary to accommodate the tax data.

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

Table 14--Increase in tax liability as a result of limiting farm losses to $10,000, $20,000, and $30,000 by Standard Administrative Regions, 1970

Region	Total returns	Total loss returns	Farm losses limited to -- $10,000			$20,000			$30,000		
			Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase	Number affected	Tax before limitation	Tax increase
	1,000			Mil. dol.		1,000	Mil. dol.		1,000	Mil. dol.	
1	28	13	0.8	9.6	4.6	0.3	5.8	2.6	0.1	1.6	1.6
2	57	28	1.8	39.9	15.7	.8	28.0	9.9	.4	18.9	6.9
3	166	78	2.0	37.3	14.6	.9	20.4	8.5	.4	13.3	5.5
4	590	264	6.5	52.7	38.7	2.2	28.8	25.1	1.1	18.7	18.5
5	730	290	6.2	54.9	30.1	1.7	34.0	18.4	.9	22.7	12.8
6	436	231	8.8	126.6	67.1	3.2	93.0	45.9	1.8	72.5	35.9
7	494	167	4.5	17.3	15.0	1.1	8.9	8.6	.4	6.3	6.1
8	192	63	2.7	8.0	14.4	1.1	5.4	8.9	.5	2.9	6.1
9	111	70	6.5	55.8	51.3	2.6	32.7	35.2	1.4	21.1	26.2
10	102	51	1.8	5.3	6.4	.6	2.5	3.3	.3	1.3	2.1
All returns	2,906	1,255	41.6	407.4	257.9	14.5	259.5	166.4	7.3	179.3	121.7

Source: Special tabulations by the U.S. Department of the Treasury, Internal Revenue Service, from the 1970 Sole Proprietorship Tax Model.

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NOTES

1/ The crop method and the so-called hybrid methods are other alternatives. Use of the crop method is limited to crops which require more than 1 year to mature and only then if the consent of the Internal Revenue Service is first obtained. The most common hybrid method requires use of an inventory and accrual accounting for purchases and sales but allows use of the cash method for all other business expenses. These alternatives are seldom used. Generally, IRS indicates that approximately 97 percent of individuals filing farm tax returns report income by the cash method. Roughly 3 percent report by the accrual method. For additional information on farm accounting methods see (9). (Underscored numbers in parentheses refer to items in Literature Cited.)

2/ United States v. Catto, 384 U.S. 102, 116 (1966).

3/ The Federal income tax rate on $12,000 of taxable income in 1939 was 11 percent. By 1942 the rate had been increased to 38 percent and reached as high as 42 percent for 1952 and 1953 (normal tax plus surtax). This rate was reduced to 38 percent in 1954 by the Internal Revenue Code of 1954 and now stands at 25 percent.

4/ Growers of citrus and almonds, in 1969 and 1970 respectively, sought and obtained Federal legislation requiring capitalization of their development expenses incurred within 4 years after planting. Section 278, Internal Revenue Code of 1954, as amended.

5/ Section 175, Internal Revenue Code.

6/ Section 182, Internal Revenue Code. As a result of 1969 legislation, if land on which expenditures deducted under sections 175 and 182 are made is sold within 5 years, the amount of expenditure must be recaptured in full. After 5 years, the amount to be recaptured decreases by 20 percent per year until no recapture is required after 10 years. The provisions of sections 175 and 182 are available at the option of the taxpayer: He may elect to capitalize or currently deduct covered expenditures up to the permissible limits.

7/ Section 180, Internal Revenue Code. This deduction, too, is optional at the election of the taxpayer. This provision was added to the Code by Congress in 1960 after the Internal Revenue Service began to question whether certain fertilizer expenses should be capitalized (6).

8/ For example, prior to the 1969 legislation, a farmer might buy a bull for $1,000, depreciate the animal down to $500 (book value) over several years and then sell it for $1,200. The entire difference between book value and sale price was then reported as a long-term capital gain. Now that portion of the gain representing depreciation previously claimed ($500) must be recaptured or treated as ordinary income and only $200 or the excess of the sale price over the original purchase is treated as a capital gain.

9/ The actual presence of farm profits is not required. The Code requires only that the taxpayer intend to show a profit from his farming operations. In a recent case, a U.S. court upheld the right of a taxpayer to deduct farm losses even though the farming operation had resulted in losses for 24 consecutive years because, in the court's view, the taxpayer successfully demonstrated the presence of a good faith intent to make a profit (5).

10/ However, a taxpayer who receives a fixed rental (without reference to level of production) is engaged in the business of farming only if he participates to a material extent in operating or managing the farm.

11/ The problems involved in identifying and defining farms are documented in (8).

12/ Under a provision of the Tax Reform Act of 1969, when an individual taxpayer's capital gain exceeds $50,000, the rate on the excess, under option (b), is 35 percent. Thus, this effectively abolishes the option for the excess, since it then becomes the same as the maximum ordinary rate on half of the gain.

13/ As long as the total amount of long-term capital gain does not exceed $50,000.

14/ Not all agricultural investments offer all three advantages. Some, such as cattle feeding, do not enable the conversion of ordinary income into capital gains but do allow tax deferral and the assured deductibility of real losses as long as intent to make a profit can be established--not too difficult an undertaking (5). For other agricultural investments--cattle breeding herds and citrus and almond groves--the conversion opportunity has been reduced but not eliminated through recent tax reforms (see 3, 10, 19, and 23).

15/ "A realistic look at the advantages to be achieved by tax sheltering confirms the good sense of the proposition...that the tax benefits are the icing on the cake. An investment which has no intrinsic merit, apart from the tax benefit, should probably be avoided" (1, p. 760). Yet, considerable evidence exists that investments of the latter type are widely promoted (10, 14, pp. 71, 80-81).

16/ These adjustments include sick pay, moving expenses, employee business expenses, and payments as self-employed persons to retirement.

17/ The definition of income used in this study is analogous to that used by Pechman and Okner in a broader study of the U.S. population (17). Tax-exempt bonds and transfer payments account for much of the difference between basic income defined above and expanded AGI as defined by Pechman and Okner.

18/ "Farm recapture property" means generally Section 1231 property (except land and buildings); that is, depreciable property held more than 6 months, cattle and horses held more than 2 years and other livestock held 1 year or more for draft, breeding, dairy, or sporting purposes; and unharvested crops sold with the land.

19/ Based on the law's test of combining farm loss and nonfarm income, 4,410 returns met the requirements for EDA in 1970, the first year for which it applied.

20/ See (6), and various House Ways and Means and Senate Finance Committee hearings.

21/ The special deductions identified were taxes; interest; abandonment, theft, fire, storm or casualty losses; drought losses and expenses; and losses on the disposition of assets to the extent they were attributable to farming.

22/ This version is found in Section 307 of H.R. 1041, 93d Congress.

23/ For purposes of comparison, a $7 tax credit is equivalent to a $14 deduction for a taxpayer in the 50-percent marginal tax bracket or a $50 deduction for a 14-percent bracket taxpayer.

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